CalPERS
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3400

December 15, 2008

AGENDA ITEM 5b

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Revision of Global Principles of Accountable Corporate Governance

II. PROGRAM: Global Equity

III. RECOMMENDATION: Recommend to the Investment Committee approval of the revised Global Principles of Accountable Corporate Governance

IV. ANALYSIS:

Executive Summary

CalPERS' Global Principles of Accountable Corporate Governance (Global Principles) support the execution of proxy voting decisions, engagement of portfolio companies, and implementation of Corporate Governance Program initiatives to maximize Total Fund investment returns. Through this agenda item, staff is recommending the following:

- Revisions to CalPERS' Global Principles of Accountable Corporate Governance, including 5 amendments to existing principles
- The inclusion of United Nations Global Compact as an appendix to the Global Principles
- The addition of a new section dedicated to the governance of joint ventures and the inclusion of Joint Venture Governance Guidelines as an appendix to the Global Principles

The Global Principles of Accountable Corporate Governance (Attachment 1) containing staff's recommended mark-up of revisions is attached to this cover memo in its entirety in addition to Wilshire Associates' opinion letter (Attachment 2).

Background

CalPERS' Global Principles allow staff to efficiently and effectively implement its Corporate Governance Program responsibilities. Staff executes all proxy voting instructions, portfolio company engagement and corporate governance initiatives in a manner that is consistent with the Investment Committee's Global Principles. The Committee has a process by which staff must, at a minimum, elevate CalPERS' Global Principles to the Committee through the Policy Sub-Committee within the first quarter of each calendar year. However, staff has the flexibility to bring revisions to the Global Principles as needed or as directed by the Committee throughout the year.

Amendments to CalPERS' Principles

Staff is recommending five amendments to existing principles that address executive compensation disclosure, executive compensation vesting methodologies, voting rights tied to unvested equity, and changing the name of the Audit Integrity section of the principles.

CalPERS currently has a principle requiring a significant portion of executive compensation be linked to the performance of the company (B.3.2a). Staff believes that a significant portion of pay should be tied to long-term performance objectives of the company and it is recommended that the language "sustainable long-term" be added to this principle. Staff believes this helps clarify the principle and reinforces CalPERS' long-term view. In addition, it strengthens CalPERS' statement that executives should not be rewarded, or penalized, for short-term swings in the market.

The second recommended amendment refers to CalPERS' principle dedicated to encouraging executives to have a significant and continuous equity investment in the company (B.3.3a). CalPERS states that policies around equity ownership should be disclosed and staff recommends extending the disclosure policy to include companies' hedging policies. Staff believes including hedging policies as part of a company's disclosure ensures an alignment of interests between company executives and the investors to ensure shareowners have a clear picture of executives' assets truly at risk.

The third amendment relates to Principle B.3.3b that states equity based compensation should incorporate performance-based components that provide for the vesting of equity grants. This current principle states that time accelerated vesting is not a desirable performance based methodology. Staff is recommending the removal of the word "time" from the principle indicating that any form of accelerated vesting is unacceptable.

CalPERS currently has a principle (B.3.3d) encouraging companies to develop and disclose a policy on recapturing dividend equivalent payouts on equity that do not ultimately vest. Staff believes it is inappropriate for anyone to receive dividends, which can be substantial income, on any equity compensation that does not vest because of termination or the failure to achieve desired performance objectives. In addition, staff is recommending that language be added to this principle to discourage voting rights on this unvested equity. Voting rights are privileges that come with share ownership and, much like dividend payments, if the equity compensation has not been earned then the right to vote should not be allowed.

Finally, staff is recommending that the title of section B.4 be changed from Audit Integrity to Integrity of Financial Reporting. All of the principles in Section B.4 relate to ensuring the integrity of financial reporting and although the auditor function is a very important part of this process it is only one part. This new title will more appropriately label this section of the principles.

Table 1 below summarizes five recommended amendments to existing principles.

Table 1
Principle Amendments

Market	Identifier	Page	Topic	Principle Amendment
Domestic	B.3.2a	11	Performance Link	Adds the language “sustainable long-term” in reference to executive compensation being tied to performance objectives.
Domestic	B.3.3a	12	Mix of Cash and Equity	Adds language regarding disclosure of executives’ holding and hedging policies related to stock ownership.
Domestic	B.3.3b	12	Equity Grants Linked to Performance	Removes the word “time” from “time accelerated vesting”, indicating that any form of accelerated vesting is not an acceptable methodology for equity grants.
Domestic	B.3.3d	12	Recapturing Dividend Equivalent Payouts	Adds language to prohibit voting rights on unvested equity.
Domestic	B.4	14	Audit Integrity	Changes the title of this section to “Integrity of Financial Reporting” to more appropriately title this section of the Global Principles.

United Nations Global Compact

CalPERS currently has a principle recommending companies adopt policies that embrace practices towards the elimination of human rights violations (B.5.1). Within this principle, two formal sets of principles are cited: The Global Sullivan Principles and The United Nations Global Compact. Currently the Global Sullivan Principles are referenced in the body of the Global Principles and a complete copy of the principles is included as Appendix E. Staff is recommending that the United Nations Global Compact's complete set of principles also be included as an appendix to the CalPERS Global Principles of Accountable Corporate Governance.

Joint Venture Governance Guidelines

By way of this agenda item, staff is recommending a new section and corresponding appendix dedicated to the governance of public company joint ventures. These Joint Venture (JV) Guidelines were developed through a cooperative effort with Water Street Partners. Water Street Partners is an advisory firm founded by David Ernst and James Bamford, widely published experts on joint venture strategy and governance, who founded and led the Alliance Practice at McKinsey & Company from 1990 to 2008.

To date, the focus of CalPERS' governance efforts has been on public companies as a whole. Staff believes a similar level of scrutiny and focus should be extended to the largest joint ventures of public companies. Below are some key data points to support this recommended new initiative:

- There are more than 1000 joint ventures with more than $1 billion in annual revenues or invested capital.
- In such industries as conventional petroleum, alternative energy, chemicals, basic materials, and aerospace, joint ventures account for upwards of 30 to 50% of many companies' economic activity.
- The 8 largest publicly listed oil and gas companies and 6 metals and mining majors have more than $500 billion in joint venture assets accounting for $72 billion in annual earnings.
- Joint ventures are central investment vehicles in key emerging markets such as China, Russia, India, Korea, Latin America, and the Middle East.

Staff believes that ensuring effective governance of material joint ventures is essential. However, governance of joint ventures also presents some unique challenges, most notably: 1) operational interdependence, 2) shared oversight and control, 3) economic flows between parent companies and the joint venture, 4) differing appetites for growth, investment, and cash flows from the parent companies, and 5) changes in the parent strategies.

To enhance investor confidence and to raise performance, CalPERS believes that companies need to raise the level of transparency, accountability, and discipline in the governance of their material joint ventures. Research shows that roughly 50% of JVs fail to meet the financial and strategic goals of the corporate parents, while 46% of joint venture announcements have a negative impact on the parents' share price. Poor governance plays a role in this underperformance. For instance, an ex-post assessment of 49 large joint ventures showed that some 50% of failures were the result of poor governance and management. In more than 100 situations where Mr. Ernst and Mr. Bamford were directly involved in restructuring major joint ventures, the ventures were routinely able to capture 10 to 30% increases in annual profitability by making changes to the governance, scope, and structure of the JVs.

CalPERS staff and Water Street Partners believe shareowners will benefit by the application of governance standards to joint ventures. These JV Governance Guidelines are an effort to drive improved performance and reduced risk within a large but relatively less transparent asset class.

<u>Next Steps</u>

Upon Investment Committee adoption of staff's recommended revisions, staff will update CalPERS' Global Principles of Accountable Corporate Governance. The Principles will then be accessible through CalPERS' website and will also be available in the form of professional glossy handouts. Staff will also update all translated versions in Chinese, French, Japanese, German, Spanish and Portuguese.

Specifically related to the adoption of the Joint Venture Guidelines, staff plans to engage companies with material joint ventures and request they adopt the Joint Venture Guidelines. Upon the Investment Committee's approval staff would begin engaging those companies who own the largest joint ventures in the global marketplace. Staff's goal is to get a few large and recognized companies to adopt the guidelines during the first year with a broader roll-out in subsequent years.

V. STRATEGIC PLAN:

This item will further goals of CalPERS' Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first to pay benefits and second, to minimize and stabilize contributions.

- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Costs associated with this item are expected to be minimal and can be absorbed within the Investment Office budget.

____
Aeisha Mastagni
Investment Officer
Corporate Governance

____
William Sherwood-McGrew
Portfolio Manager
Corporate Governance

____
Eric Baggesen
Senior Investment Officer
Global Equity

____
Anne Stausboll
Interim Chief Investment Officer